DOW THEORY LETTERS INC.

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THE MARKET: Reflections early in the California morning: One senses with the huge N.Y.S.E. volume, the sudden rush-up of a stock here, the doubling of a price there, the flood of new investment services (see any issue of Barron's), that we are in the throes of a climactic phase on Wall Street. The bull market which scraped together only 272 million shares in its first year (1949) is now turning over 30 to 45 million shares a week. The "crash day" in the 1937 bear market brought out 7 million shares, and that day stood as one of the five "biggest days in exchange history" for a generation. But today 7 million shares is commonplace. Yesterday's rarity is merely a statistic today.

The investment business (like everything else) becomes "sophisticated," "streamlined," and as new services enter the field to try their hand at the game, the pressure to "be a genius" envelopes the field. Doubts become tantamount to cowardice, patience becomes "a costly policy of do-nothing," and a rash of new systems is announced. One reads the advertisements in the Sunday New York Times Financial section, and the atmosphere one senses is that of a pressure cooker with the flame too high. It's Wall Street a-go-go, and the customers join in the dance.

The technicians and market students struggle with the massive record-crunching statistics. Isn't the short interest up for four months in a row? Hasn't that always meant 4 to 10 months more of rising prices? Aren't the odd-lotters still cautious? Can a market "top" without a spate of odd-lot enthusiasm? If one listens, can't one hear a "rumbling" on Wall Street, a "shaking of the earth" which is moving from East to West? It's the volcano activating, cries the student of crowd psychology, and by this winter or spring the volcano will be erupting into speculative excesses, the likes of which this generation has never seen.

As it does on rare occasions, the market becomes "bigger than life," it becomes a "force" which is too great for the usual measurements. But wait, cautions the student, haven't the Averages always told the story. Didn't they tell the story in 1929 when "reading the averages" seemed tantamount to studying a jig-saw puzzle in the eye of a hurricane? In retrospect, every movement in history has been hinted at or foretold by the action of the Averages. It remains for us to read the Averages correctly.

* * * *

It can be tedious (but also important) to study the daily or minor trend. Primary movements are composed of a series of secondary movements, and secondary movements grow out of a series of minor movements. A pyramid, no matter how high, is made up of thousands of blocks. The Industrial and Rail Averages recorded all-time highs in early November (see chart 1).

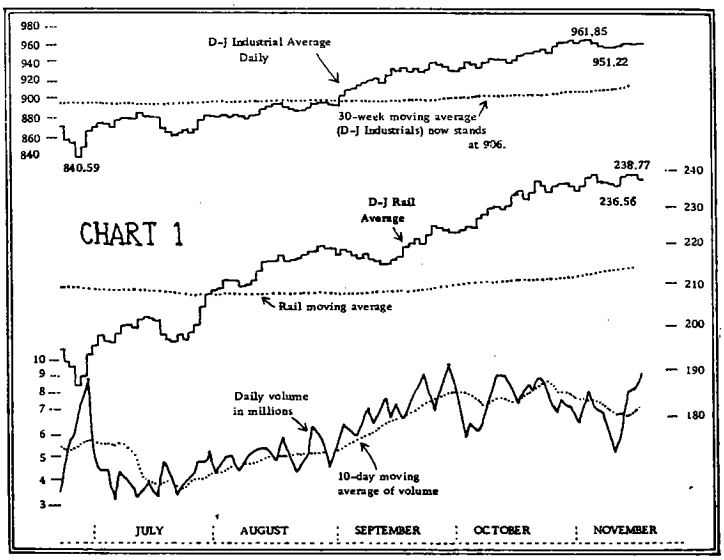
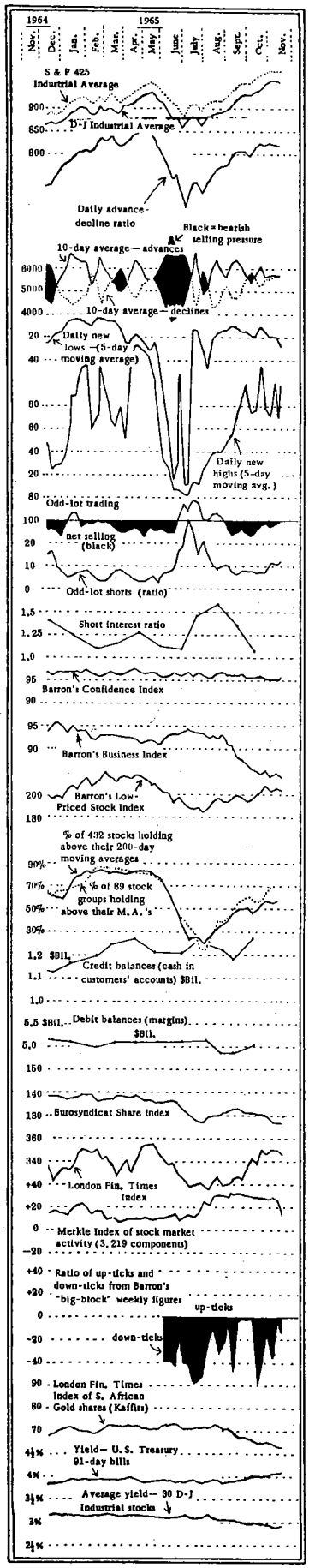


CHART 1


1964
1965
S & P 425 Industrial Average
D-J Industrial Average
Daily advance-decline ratio
Black = bearish selling pressure
10-day average — advances
10-day average — declines
Daily new lows (5-day moving average)
Daily new highs (5-day moving avg.)
Odd-lot trading
net selling (black)
Odd-lot shorts (ratio)
Short interest ratio
Barron's Confidence Index
Barron's Business Index
Barron's Low-Priced Stock Index
% of 432 stocks holding above their 200-day moving averages
% of 89 stock groups holding above their M.A.'s
Credit balances (cash in customers' accounts) $Bil.
Debit balances (margins) $Bil.
Burosyndicat Share Index
London Fin. Times Index
Merkle Index of stock market activity (3,219 components)
Ratio of up-ticks and down-ticks from Barron's "big-block" weekly figures
up-ticks
down-ticks
London Fin. Times Index of S. African Gold shares (Kaffirs)
Yield — U.S. Treasury 91-day bills
Average yield — 30 D-J Industrial stocks

A minor decline then took Industrials to 951.22, Rails to 236.56. As far as Dow's Theory is concerned, these are the near-term "marker points." The last Letter stated that the primary and secondary trends are bullish, while the minor trend was termed "obscure." As long as one or both Averages now hold above the 951.22 and 236.56 levels, the indications will be bullish for all three trends. But a breaking of 951.22 and 236.56 on increasing volume will mean that the minor trend has turned bearish. If there is to be trouble ahead, a bearish designation for the minor trend will be the necessary "step one."

The Composite Chart (Page 1) shows the two leading industrial averages at approximate record highs with the A-D ratio still holding in its October-November sideways range. New lows have been creeping up, but new highs have also been holding at an impressive level. The swing from heavy odd-lot selling (black area) to roughly equal buying and selling represents a change in sentiment, and the odd-lot picture no longer represents a near-term plus for the market. The Confidence Index recovered from its recent 95.2 low to 95.6, but this week saw the D-J 40 Bond Index drop to a two-year low. The Merkle Index (computed by Dan Merkle of Traders Research, 1431 Pearl St., Alton, Ill.) dropped to 17 this week, but it is still holding above its critical zero level. Under the strain of the Rhodesian crisis, both the British market and the S. African gold shares are retreating. The bellwether 91-day Treasury bills provided yields of 4.097%, highest yields in 5 years. The Barron's computations of big block transactions showed a ratio of minus 17 this week, suggesting more big money distribution. Conclusion: for the near-term, the A-D ratio and odd-lot sentiment may provide the best gauge of market strength or weakness. The A-D ratio is in a position where further refusal to rally could bring on trouble.

QUESTION: "Recently San Francisco papers carried a news item of an address by Dr. Pierre A. Rinfret to 750 industrialists and bankers in New York. He predicted that the U. S. will be forced off the gold standard and that 'at the rate of gold losses now we will be out of gold by the second quarter of 1967.' Dr. Rinfret was cited by President Johnson nineteen months ago as a 'leading industrial economist' and his forecasts are said to be watched closely in the White House.

"Opinions have been expressed by numerous economists as to what might happen to our economy and the stock market if the U. S. placed an embargo on gold and under various international agreements for settling balances of payments in units tied to gold. But we have seen no forecasts as to what might happen if the U. S. simply went off the gold standard with complete demonitization of the dollar. We have seen this predicted by some, but with no elaboration of what might follow.

"It would be very interesting to hear your own speculations on this possibility and the consequences in a Dow Theory Letter." (D. R. DeMarce, Palo Alto, Calif.)

ANSWER: A drastic and fundamental change in U. S. coinage is underway. Two weeks ago, we saw the inauguration of the "new" cupronickel quarters, coins which are actually worth about 20% of their face value. Despite wide-spread hoarding of the old quarters (which possess an intrinsic value based on the market value of silver), there has been no panic and no disposition on the part of the American people to refuse the new quarters. Why have Americans accepted these base metal quarters? The answer is confidence. The American people are confident that the new quarters will continue to purchase a fourth of a dollar's worth of goods, regardless of the intrinsic value of the ersatz quarters.

But the question is, would foreigners be as complacent? Would they accept paper dollars with nothing behind them but the U. S.'s insistence that these dollars will continue to buy a dollar's worth of goods? If the U. S. demonetized, we would then have a situation where the world's greatest trading nation would be issuing currency, the value of which would be unknown (since it would not be linked with gold). In that case, since foreigners have tended to show less and less confidence in the dollar over the past few years (witness the manner in which they have been turning in their dollars for gold), I would expect the dollar to collapse in foreign exchange markets. If demonetization occurred, there would be a rush to exchange dollars for any gold-backed currency. There would also be panic selling of U. S. properties and stocks in an effort to obtain dollars and then turn these dollars into gold-back foreign currency.

A complete demonetization of the dollar would be an admission of U. S. bankruptcy as far as foreigners were concerned, and it would mean that the U. S. Government, with no restrictions whatever, would be able to expand its current policy of inflating the money supply — with no limits in sight. The spector of an endless flood of dollars would remove any vestige of confidence in the dollar. When you lose confidence in a stock, you sell it. When you lose confidence in a currency, you get rid of it. Frankly, I believe that the Administration is beginning to recognize this fact — it is simply a question of whether they will do anything about it.

"READING" THE AVERAGES: Despite the fact that the D-J Industrial and Rail Averages are probably the two most widely followed "indicators" on Wall Street, few people have really made a study of the meaning of their movements, at least in Dow Theory terms. Most are aware that it is a bull movement as long as the two Averages continue to rise above preceding peaks, and if volume increases with the rise the authority of the successive upward penetrations is heightened (the converse, of course, is true during bear movements.

Robert Rhea usually designated the minor trend (as opposed to the secondary and primary trend) bearish whenever the two Averages traced out a single downward zig-zag, particularly if volume tended to expand as the first set of low points was broken.

But when is it correct to state that the secondary trend is down? This is more difficult to determine with accuracy, but when two or more downward zig-zags are formed in both Averages, Rhea noted that the secondary trend was probably in the process of turning down.

A secondary reaction in a bull market differs from a mere decline both in duration and extent, but unfortunately, even here the determination is not always clear. Rhea stated that any correction of around 5% of the preceding advance should be labeled a decline. On the other hand, he observed that most true secondary reactions tend to retrace 1/3 to 2/3 of the preceding uncorrected rise while lasting anywhere from 3 weeks to 3 months. This is clear enough, but it is the many movements which fall in between these two approximate classifications which are likely to trouble students. What should we label a movement which retraces say 20% of the preceding rise in a matter of perhaps two weeks? In the in between cases, the market practitioner is in the position of simply having to decide for himself.

Rhea did point out that most secondary reactions tend to take the form of two (or more) distinct downward movements with one (or more) upward corrections. Along these lines, we might be less prone to accept a straight-line drop which retraced 18% of the preceding rise over a period of 5 days as a secondary than say a large downward zig-zag which corrected 18% of the preceding rise in a period of three weeks. Volume characteristics should also be given carefull consideration. For instance, if volume tended to dry up as the decline progressed, the secondary classification would be more dubious than if volume tended to rise to climactic proportions as the market continued down.

In order to record a primary bear signal, it is necessary first to have a full secondary reaction, then an advance of a few weeks or longer which fails to take both Averages above the old highs, and finally a new decline which carries both Averages below the original secondary lows. Volume implications are extremely important in determining whether a primary bear signal has been given, and volume should be expected to expand significantly as the lows are broken. As always, the authority of the penetrations is greatly heightened if both Averages break the lows simultaneously or within a few days of each other.

In my own experience I have found that two factors enhance the authority of any penetrations: (1) increasing volume as the penetrations are made, (2) closeness (in time) of the penetrations or preferably simultaneous penetration of the two Averages. A few students might remember that following the 1962 collapse which ended in June, both Averages rose to highs in August. A new decline carried into October (the Cuban crisis), followed by a second rise. On November 9 both Averages penetrated their August peak simultaneously. The authority of that rare simultaneous penetration can now be judged in retrospect.

The question might be asked: "What would we do if the two Averages were suddenly to turn down and just keep going down — without the 'normal' retracement and subsequent bear signal. In other words, if we were to have a straight-line collapse, at what point would we call it a bear market and sell everything?"

QUOTES of the day and signs of the times: (From Newsweek, Nov. 15, 1965) "..the simple fact is that (Southern California's) postwar building boom has fallen flat on its stucco facade. From the peak period 21 months ago, home construction has plummeted 35%, to a rate of only 52, 500 units a year. Apartment construction has slumped even more — a whopping 71% from the 1964 peak to a rate of 43, 800.... The consequences of the collapse are apparent in the financial reports from California savings & loan associations, which provided much of the thrust for the building boom.... Fighting back, builders have been offering big discounts (as much as $8, 000 on a $50, 000 house) and dangling such exotic lures as a free Mustang for the carport. Yet, last week, throughout the Los Angeles area, some 80, 000 houses were waiting to be sold."

(Time Magazine, Nov. 15, 1965, from an article about New York City and its new mayor) "The city is deep in hock and going deeper; interest on its debt alone is $1.4 million daily — more than the cost of police, fire and sanitation services combined."

(From an article, "New Men of Wall Street" in the London Economist, Nov. 6, 1965) "But in Wall Street a growing impact is now being made by young dynamic firms staffed by bright new men, who cater almost exclusively for institutional and corporate funds and make their distinctive offering not only a different kind of services but a different investment philosophy, which the New Era in economics is said to demand. That pitch in itself will be enough to send shivers down the spines of those who recall an earlier new era in American business just over a generation ago: and assurances such as 'the market is speculative but will go higher' and 'business liquidity is low but stocks will still rise' do not exactly allay such doubts."

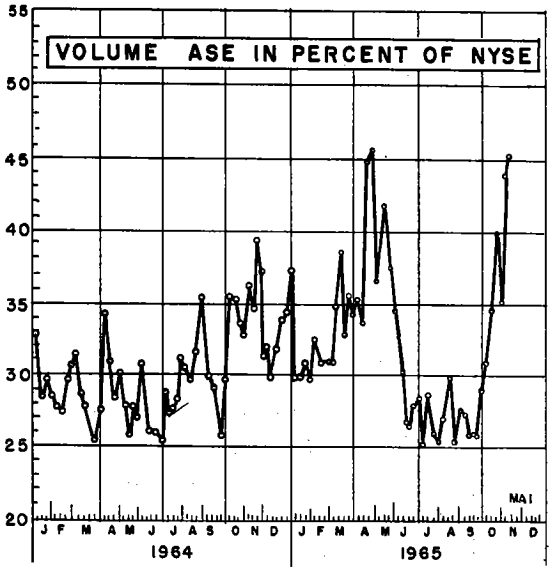
(From Melchior Palyi's Chicago Tribune column, Nov. 9, 1965) "The International Monetary fund lists 27 countries as having gold-convertible currencies. Actually not a single national money is redeemed by the authorities into gold for domestic owners. This is one of the very few earmarks they all share, democracies and totalitarians alike. Nor is there a single country that would adjust the domestic money supply to the gold reserve as was the case in the pre-1914 gold standard... Presently, every single government disclaims any intention to turn back the monetary clock, but most governments and central banks are longing for the stability that had been obtained under (the pre-1914) rule. Under that rule, per capita real national income grew at an average annual rate of 3%, better than double our post-1940 rate of growth, and the world enjoyed the benefits of monetary stability."

This would indeed be a rare occurence, but Rhea wrote: "When declines in a primary bull market result in violating the last major secondary reaction of that market, it may be assumed that the primary trend has changed from bullish to bearish." Therefore, in the present instance we can say that if the market turned down, and an uninterrupted decline resulted in taking both Averages below their June, 1965 lows on heavy volume, the primary trend would then be classified as bearish.

THOUGHT OF THE WEEK: (from the New York Times, Nov. 12, 1965): "The Johnson Administration got the aluminum industry to withdraw its price increases without an open battle or a prolonged delay. But it is unlikely that relations between the President and the business community will ever again be as smooth and as sweet as they had been. Businessmen now recognize that the Administration is very much the senior member of the partnership that Mr. Johnson has established. On key issues, particularly on price stability, the Administration is determined to have its way.

"This may be hard for businessmen to take, if only because Mr. Johnson had seemed to imply that they were full and equal partners. Now, the honeymoon — and the illusions — are over, and though business and Government will have to get along together somehow, there is no longer any doubt about who wears the pants."

CHART OF THE WEEK: Only once before in the last two years has volume on the speculative Amex Exchange surged to 45% of N.Y.S.E. volume. This highly volatile phenomenon occurred last during April, 1964, prior to the May-June drop. It remains to be seen whether history repeats. (Chart courtesy of Merrill Analysis, Box 228, Chappaqua, N.Y. 10514)



STOCKS: The following stock groups are listed by Chartcraft, Larchmont, N.Y., as the strongest of 89 groups on the basis of relative strength momentum studies. (1) Machine Tools, (2) Radio-TV Mfgs., (3) Airlines, (4) Aerospace, (5) Metal Fabrication. Weakest groups are (85) Sugar Cane Producers, (86) Mail Order Stores, (87) Cigar Mfgs., (88) Cement, (89) Brewers.

One of the best methods of gauging strength or weakness in individual stocks continues to be relative strength or the performance of an issue compared with "the market" (any broad stock average will serve to represent the market). Traders Research runs daily relative strength

(R. S.) charts plus a 200-day moving average of R. S. It should be remembered that weakness in individual stocks stands out most dramatically when the general market is in a rallying phase, while strength in individual shares shows itself best during a general decline.

Letter 292 (June 24) discussed R. S. performance, calling attention to the strong R. S. performance in Lockheed (then selling for 46) and the weak R. S. performance in Wilson (selling for 45). Note on the chart below (courtesy of Traders Research) that the exceptional R. S. performance in Lockheed has continued in effect. Lockheed's R. S. line rose through all market fluctuations of 1965, and its 200-day R. S. line has continued steadily higher to this week. Compare this with the current performance of a typical Steel stock, Inland Steel. Here we see the R. S. line holding below the 200-day average of R. S., despite the (low volume) September-October rally. The R. S. study is saying that Inland is not a buy, and this is true for most of the other big steels such as Beth. St., U. S. St., Republic St., Youngstown.

One "blue-chip" which has been showing declining R.S. for 5 years (since 1961) is Minnesota Mining & Mfg. On the daily chart we see MMM's R.S. line pushing above its 200-day moving average of R.S. while a "double bottom" seems to have formed at the 54 level in the stock. The "breakout" will come if and when the stock pushes into the 66-68 level.

SAN DIEGO: Many subscribers (particularly those of retirement age) have asked me for more facts about San Diego. They seem fascinated with the idea that a life-long New Yorker would suddenly pick up his family and his business and move to the West Coast (and not San Francisco or Los Angeles at that!).

"Why San Diego?" The answer: it was partly through a study of geography and the weather map, partly love at first sight. I wanted the best possible climate. This eliminated Florida which has lovely winters but hot, bug-ridden summers. The only other sub-tropical climate in the U. S. is found in California — but where should one live in California? San Francisco is beautiful, cosmopolitan, but its climate leaves much to be desired. L. A. is a "big action" city, but it is crowded, covered with smog. That leaves Santa Barbara and San Diego. Santa Barbara is charming, but it is too small, even a bit ingrown. Finally one turns to San Diego, a city few in the East know anything about ("Where is it, north or south of L. A.?").

S. D. is the 17th largest city in the U. S. (pop. 630,000), it boasts the finest climate in the U. S. (if not the world). S. D. temperatures run roughly 10 degrees either side of 68 all year round. Nights are cool, days are warm. Rain is usually restricted to a few months in the "winter," and average rainfall is about 10" (vs. 14" in L. A., 42" in N.Y.C.). It has been said that S. D. is the only place in the nation where you can plan a picnic a month away and know you will have a perfect day.

Although the climate is even, S. D. is a city of extraordinary contrasts. It boasts a new University, 7 colleges, the great Scripps institute of Oceanography, the new Salk Institute. Within the S. D. area live 4 nobel prize winners, 15 members of the National Academy of Science. Yet with it all, S. D. retains its Western flavor, and, in fact, has one of the largest real cowboy populations in the West (in Sweetwater, 15 miles south of here, they hold free rodeos every Saturday and Sunday "just for practice"). S. D. has the world's largest and most beautiful zoo, it boasts a ridiculously large population of pretty girls, and like much of California, S. D. seems to put on a new beauty contest every other day ("Miss Tangerine, "Miss Desert Flower," etc.). S. D. has the only special beach in the nation devoted exclusively to surfing, it has some of the world's best gardens (anything from orchids to avocadoes and Cacti grow here with ease), it has one of the nation's lowest crime rates. S. D. has a huge desert (the Anzo-Borrego) within two hours' ride of the City, it has miles of beaches, both well populated and deserted, and it possesses every sort of boating facility.

Besides being an ideal place to retire, S. D. is a perfect place to run a business, particularly one which needs a steady source of reasonably priced white collar personnel. Although there are almost no factories here (and thus no smog), there are many science and service businesses. The price of white colar labor in S. D. runs considerably below L. A. and N.Y.C. rates, perhaps 20 to 30% below. Living is relatively inexpensive here, houses can be purchases or rented reasonably. Biggest savings, Easterners will find, are clothing (you can wear cottons all year round in S. D.) and entertainment (fewer nightclubs, more beaches and outdoor life will save you money here).

For exotic fare there is Las Vegas, the world's best sports fishing off Baja, skiing in the mountains. Then there is Mexico with its Sunday bullfights, its crowded flashy border towns (Tijuana is half an hour from this office), its magnificent scenery, and its sleepy interior towns (one can be in Tacate, Mexico, in an hour, and during the week the odds are that you will not see another Yankee within miles).

Approximately a dozen subscribers have informed me that they have moved here because of my glowing descriptions of the San Diego area. None of my new neighbors have complained yet.

LATE NOTE: It has been announced that the Government is going to release a huge stockpile of copper. Thus another industry is "on the line" to reduce its prices. Businesses with foreign interests have had to cut back on overseas' expansion, steel and aluminum have had to keep prices down. What first appeared to be isolated "examples" now promises to be a new "guided way of life" for business. It should be quite a show before its all over.